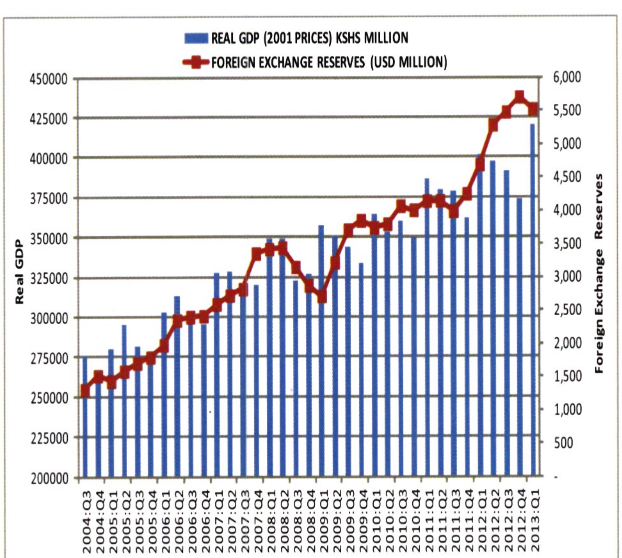

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CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

JUNE 2013

Letter of Transmittal to the Cabinet Secretary for The National Treasury

PARLIAMENT OF KENYA LIBRARY

Dear Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the 32nd Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. It reviews the outcome of the monetary policy stance in the second half of the Fiscal Year 2012/13, then describes the current economic environment and outlook, and concludes with an outline of the monetary policy stance for the Fiscal Year 2013/14.

Prof. Njuguna Ndung'u, CBS
Governor

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The Principal Objectives of the Central Bank of Kenya

The principal objectives of the Central Bank of Kenya (CBK) as established in the CBK Act are:

(1) To formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices;
(2) To foster the liquidity, solvency and proper functioning of a stable, market-based, financial system;
(3) Subject to (1) and (2) above, to support the economic policy of the Government, including its objectives for growth and employment.

Without prejudice to the generality of the above, the Bank shall:

- Formulate and implement foreign exchange policy;
- Hold and manage Government foreign exchange reserves;
- License and supervise authorised foreign exchange dealers;
- Formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;
- Act as banker and adviser to, and as fiscal agent of, the Government; and
- Issue currency notes and coins.

The CBK therefore formulates and conducts monetary policy with the aim of keeping overall inflation within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent. The achievement and maintenance of a low and stable inflation rate together with ensuring adequate liquidity in the market facilitates higher levels of domestic savings and private investment, and therefore leads to improved economic growth, higher real incomes and increased employment opportunities. The Bank's monetary policy is therefore designed to support the Government's desired growth in the production of goods and services and employment creation through achieving and maintaining a low and stable inflation.

Instruments of Monetary Policy

The CBK pursues its monetary policy objectives through the following instruments:

- **Open Market Operations (OMO):** refers to actions by the CBK through purchases and sales of eligible securities to regulate the money supply and the credit conditions in the economy. OMO can also be used to stabilise short-term interest rates. When the Central Bank buys securities on the open market, it increases the reserves of commercial banks, making it possible for them to expand their loans which increase the money supply. To achieve the desired level of money supply, OMO is conducted using:
  - **Repurchase Agreements (Repos):** Repos entail the sale of eligible securities by the CBK to reduce commercial banks' deposits held in CBK. Currently, Repos (often called *Vertical Repos*) have a fixed tenor of 7 days. *Reverse Repos* are purchases of securities from commercial banks by the CBK during periods of tighter than desired liquidity in the market. The *late Repo*, sold in the afternoon, has a 4-day tenor and is issued at an interest rate 100 basis points below the Repo on that day.
  - **Term Auction Deposits (TAD):** The TAD is used in exceptional market conditions when the securities held by the CBK for Repo purposes are exhausted or when CBK considers it desirable to offer longer tenor options. The CBK seeks to acquire deposits through a transfer agreement from commercial banks at an auction price but with no exchange of security guarantee. Currently, the deposits are transferred to the CBK for a 14, 21, or 28 day period after which they revert back to the respective commercial banks' on maturity of the transfer agreement.

Horizontal Repos are transacted between commercial banks on the basis of signed agreements using government securities as collateral, and have negotiated tenors and yields. Commercial banks, short of deposits at the CBK, borrow from banks with excess deposits on the security of an appropriate asset, normally government securities. Horizontal repos help banks to overcome the problem of limits to lines of credit, thus promoting efficient management of interbank liquidity. They are not strictly monetary policy instruments but modes of improving liquidity distribution under CBK supervision.

- **Central Bank Rate (CBR)**: The CBR is the lowest rate of interest charged on loans to commercial banks by the CBK. The level of the CBR is reviewed and announced by the Monetary Policy Committee (MPC) at least every two months and its movements,both in direction and magnitude, signals the monetary policy stance. In order to enhance clarity and certainty in monetary policy implementation, the CBR is the base for all monetary policy operations. Whenever the Central Bank is injecting liquidity through a Reverse Repo, the CBR is the lowest acceptable rate by law. Likewise whenever the Bank wishes to withdraw liquidity through a Vertical Repo, the CBR is the highest rate that the CBK will pay on any bid received. Movements in the CBR are transmitted to changes in short-term interest rates. A reduction of the CBR signals an easing of monetary policy and a desire for market interest rates to move downwards. Lower interest rates encourage economic activities and thus growth. When interest rates decline, the quantity of credit demanded should increase. The efficiency of the repo and interbank markets is crucial for the transmission of monetary policy decisions. The CBK monitors, but does not intervene, in the overnight interbank money market which is conducted by the banking industry.
- **Standing Facilities**: The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a penal rate that is over the CBR. The rules governing the operation of the CBK Discount Window are reviewed from time to time by the Bank. Currently, banks utilising the CBK Overnight Window are charged the CBR plus a high penalty. Moreover, banks making use of this facility more than twice in a week are scrutinised to establish whether prompt corrective action is required to address any weakness that is not merely temporary.
- **The Cash Reserves Ratio (CRR)**: In accordance with the law, the CRR is the proportion of a commercial bank's deposit liability which must be deposited at CBK. These deposits are held in the CRR Account at no interest. The ratio is currently 5.25 percent of the total bank domestic and foreign currency deposit liabilities. To facilitate commercial banks' liquidity management, commercial banks are currently required to maintain their CRR based on an average level from the 15th of the previous month to the 14th of the current month and not to fall below a CRR of 3 percent on a daily basis. A reduction in the CRR releases liquidity thus enhancing the capacity of commercial banks to expand credit. An increase in the CRR tightens liquidity and could also dampen demand-driven inflationary pressures.

- **Foreign Exchange Market Operations**: The CBK can also inject or withdraw liquidity from the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks withdraws liquidity from the system while the purchase of foreign exchange injects liquidity into the system. Participation by the CBK in the foreig exchange market is usually motivated by the need to acquire foreign exchange to service official debt and build its foreign exchange reserves where the statutory requirement is to use the Bank's best endevours to maintain a foreign reserves equivalent to a three year average of four months' import cover. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya shilling but may intervene to stabilise excess volatility in the exchange market. The following regulatory measures have been introduced, through Prudential Guidelines of banks, to support stability of the exchange rate:
    i. Limiting the tenor of swaps and Kenya Shilling borrowing where offshore banks are involved to a tenor of not less than one year.
    ii. Limiting the tenor of swaps between residents to not less than seven days.
    iii. Reduction of the foreign exchange exposure ratio of core capital from 20 percent to 10 percent.
    iv. Requiring that local banks obtain supporting documents for all transactions in the Nostro accounts of offshore banks.
    v. Suspension of the use of Electronic Brokerage System by banks.

- **Licensing and Supervision of Financial Institutions**: The Bank uses the licensing and supervision tools to ensure the health and efficiency of the banking system; this includes vetting potential managers for suitability both with respect to qualifications and character.

- **Communication**: The increasing use of communication media ensures a wider dissemination of monetary policy decisions and background data thereby increasing the efficiency of information transmission. The regular interaction between the MPC and the Chief Executive Officers of commercial banks through the Kenya Bankers Association (KBA) has ensured that monetary policy decisions are transmitted to the banking sector. The CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates and results of auctions of government securities.

Legal Status of the Monetary Policy Statement

1. Section 4B (1) of the CBK Act requires the Bank to submit to the Cabinet Secretary for The National Treasury, at intervals of not more than six months, a Monetary Policy Statement for the next twelve months which shall:
    i. Specify policies and the means by which the Bank intends to achieve its policy targets;
    ii. State reasons for adopting such monetary policies and means; and
    iii. Contain a review and assessment of the progress made in the implementation of monetary policy by the Bank during the period to which the preceding Monetary Policy Statement relates.
2. The Cabinet Secretary shall - by the law under subsection (1) - lay every Statement submitted under subsection (1) before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the Statement is so submitted.

3a. The Bank shall – by law – publish in the Kenya Gazette:

i) Its Monetary Policy Statement; and
ii) Its Monthly Balance Sheet.

3b. The Bank is further required to disseminate key financial data and information on monetary policy to the public.

4. In subsection (2), the expression "appropriate committee" means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

Executive Summary

This Monetary Policy Statement reviews the outcome of the monetary policy stance adopted in the second half of the Fiscal Year 2012/13 and provides the policy stance for the Fiscal Year 2013/14 with focus on the first six months.

The monetary policy stance adopted by the Monetary Policy Committee (MPC) in the second half of the Fiscal Year 2012/13 resulted in: the achievement of the targets in the monetary programme; overall inflation remaining within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent; and, exchange rate stability. Overall month-on-month inflation increased from 3.20 percent in December 2012 to 4.91 percent in June 2013 as a consequence of an increase in food prices coupled with the impact of the base effect attributed to the decline in the Consumer Price Index in mid-2012. However, non-food-non-fuel inflation, which measures the impact of monetary policy, declined from 4.81 percent to 3.86 percent during the period. The Central Bank of Kenya (CBK) foreign exchange reserves stood above the minimum requirement of an equivalent of four months of import cover in June 2013. Stability in the interbank market during the period was supported by effective liquidity management while the Central Bank Rate (CBR) was the base for all monetary policy operations.

In view of the outcomes of a low and stable inflation rate and exchange rate stability in the second half of the Fiscal Year 2012/13, the MPC continued with its gradual easing of the monetary policy stance that it had initiated in July 2012. This stance was aimed at supporting economic activity through non-inflationary credit growth. The policy stance in the second half of 2013 will therefore be aimed at maintaining the overall month-on-month inflation rate within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent. The Bank will also continue building its foreign exchange reserves in line with prudent management policies.

During the Fiscal Year 2013/14, monetary policy will seek to control the annual growth in broad money supply, M3, to 14.2 percent by September 2013, 14.0 percent by December 2013, 13.6 percent by March 2014 and 13.3 percent by June 2014. The Net Domestic Assets (NDA) of the Bank is projected at Ksh -64.8 billion in September 2013, Ksh -57.1 billion in December 2013, Ksh-76.1 billion in March 2014, and Ksh-87.8 billion in June 2014. These NDA targets are consistent with the indicative Extended Credit Facility (ECF) programme. However, the annual growth in credit to the private sector is projected at 16.9 percent in September 2013, 16.2 percent in December 2013, 15.5 percent in March 2014, and 14.1 percent in June 2014. The indicative ECF targets for Net International Reserves (NIR) targets of the CBK are USD 4,350 million in September 2013 and USD 4,450 million in December 2013. The monetary policy stance will aim to ensure that movements in the short-term interest rates are supportive of the inflation objective.

The main risks to the macroeconomic outlook relate mainly to the high current account deficit, and the current instability in the Middle East and North Africa (MENA) and Eurozone which are a threat to the general stability of prices. Disturbances in the MENA region could affect the price of oil and tea exports. This could have balance of payments and inflation implications. In addition, significant base effects arising from the decline in the Consumer Price Index in mid-2012 will exert non-policy related pressure on overall inflation. The CBK remains vigilant to these risks and will take appropriate actions to maintain price stability.

The Bank will also continue with its regular interactions with stakeholders in the financial and real sectors, including the Kenya Bankers Association (KBA), and timely release of relevant monetary and financial data. This will enhance the transmission of monetary policy signals and coordinate market expectations.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines and broad targets for the CBK over the Fiscal Year 2013/14 concentrating particularly on the first six months. It also presents the policy outcomes in the second half of the Fiscal Year 2012/13.

During the second half of the Fiscal Year 2012/13, the monetary policy stance adopted by the MPC sustained inflation within the target bounds set by the Government as well as exchange rate stability. Increased confidence in the economy following the peaceful elections in March 2013 coupled with resilient diaspora remittance inflows are among the key factors which have been supporting exchange rate stability. A notable outcome of the gradual easing of the monetary policy stance during the second half of the Fiscal Year 2012/13 has been the pick-up in growth of credit to the private sector to the main sectors of the economy. However, the current instability in the Middle East and North Africa (MENA) and Eurozone coupled with persistent balance of payments pressures due to a high current account deficit remain the main threats to exchange rate stability.

Monetary policy formulation and implementation continues to be guided by the Government Budget Policy Statements and the ECF programme where targets for NDA and NIR are the operational parameters. The Bank also continues to monitor targets for key monetary aggregates such as broad money supply, M3, and credit to the private sector. The Bank's participation in the foreign exchange market will continue to be guided by the need to accumulate and maintain foreign exchange reserves at /or above the level of four months of import cover as well as purchasing foreign exchange to meet the Government's external obligations, and ensuring stability of the value of the Kenya shilling.

The rest of this Policy Statement is organised as follows. Section 2 reviews the outcome of the monetary policy stance proposed in the December 2012 MPS while Section 3 outlines the current economic environment and outlook for the Fiscal Year 2013/14. Section 4 concludes by outlining the monetary policy stance proposed for the first six months of the Fiscal Year 2013/14.

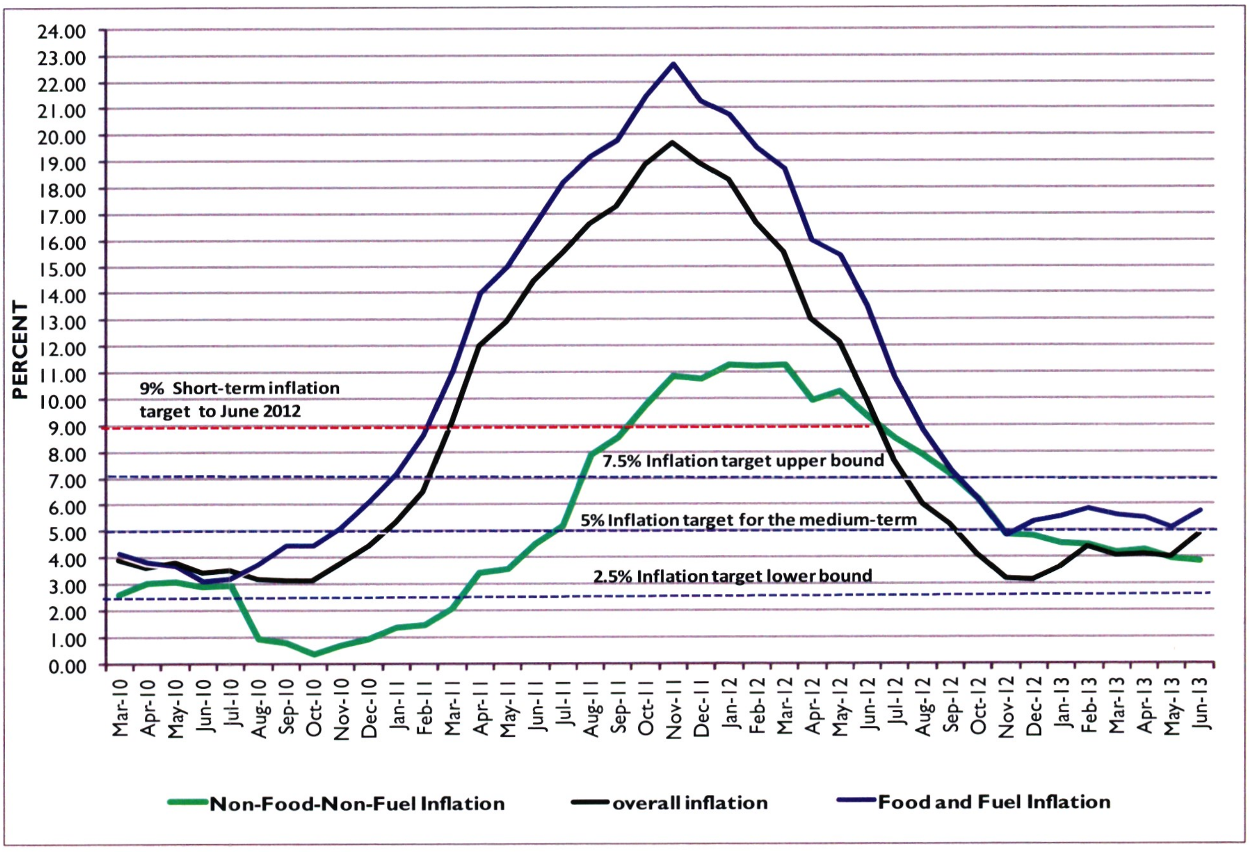
2. Actions and Outcomes of Policy Proposals in the December 2012 Monetary Policy Statement

The overall aim of the Monetary Policy Statement for December 2012 (31st MPS) was to set monetary policy targets that would ensure low and stable inflation, encourage growth, support long-term sustainability of public debt through stable interest rates and by enhancing financial access within the economy to contribute to lowering the cost of doing business in Kenya. The frequency of MPC meetings was retained at bi-monthly during the second half of the Fiscal Year 2012/13 as a consequence of a decline in the risks to the inflation outlook and sustained macroeconomic stability following the peaceful elections in March 2013. The following are the specific outcomes of the policy proposals in the 31st MPS:

a. Inflation

The primary objective of monetary policy formulation and implementation is price stability. During the second half of the Fiscal Year 2012/13, both overall and non-food-non-fuel inflation remained within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent (Chart 1). However, overall month-on-month inflation increased from 3.20 percent in December 2012 to 4.91 percent in June 2013 reflecting an increase in food prices coupled with the impact of the base effect attributed to the decline in the Consumer Price Index in mid-2012. However, non-food-non-fuel (NFNF) inflation, which measures the impact of monetary policy, declined from 4.81 percent to 3.86 percent during the period. The decline in NFNF inflation in the period reflected easing demand pressure in the economy following tight stance adopted by the MPC in the first half of 2012.

Chart 1: Trends in Inflation (CPI base February 2009=100)

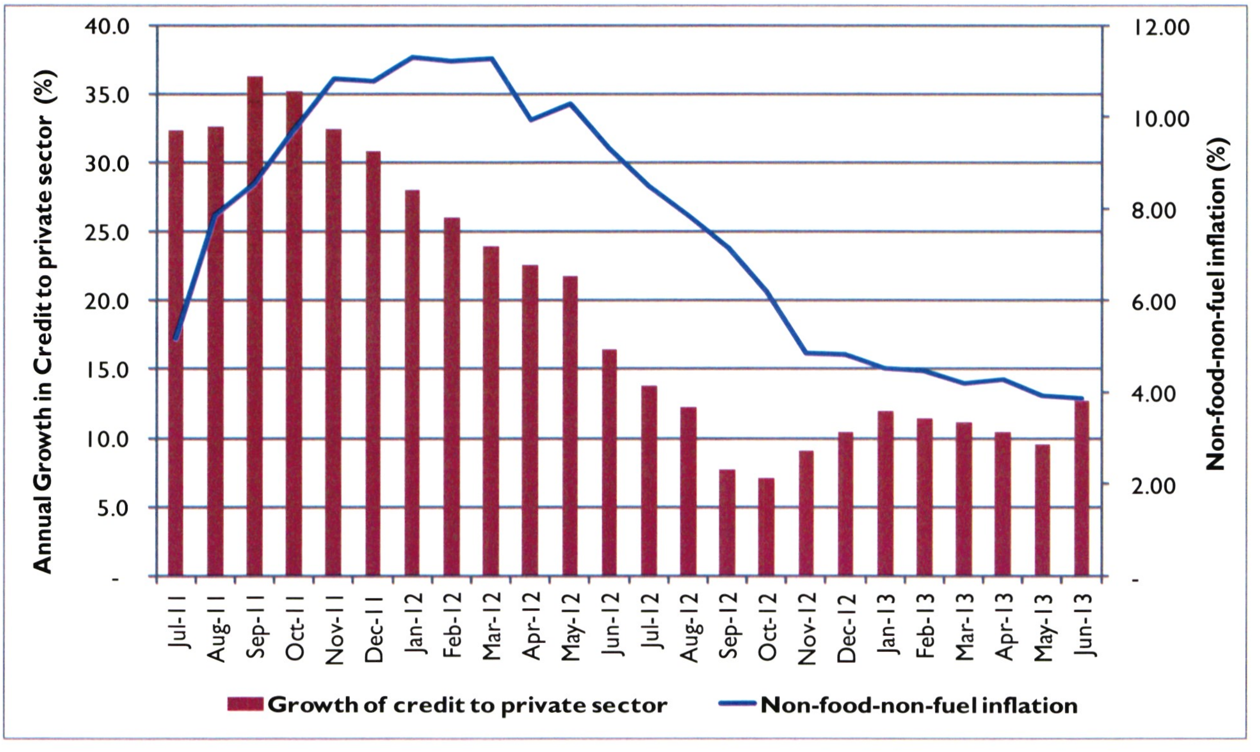


Source: Kenya National Bureau of Statistics and Central Bank of Kenya

i. Credit to Private Sector

The gradual easing in the monetary policy stance adopted by the MPC in the Fiscal Year 2012/13 resulted in a non-inflationary credit expansion in the period (Chart 2). In addition, the slowdown in the annual credit growth in the 2012 supported the decline in non-food-non-fuel inflation during the period. The reduction of the Central Bank Rate (CBR) from 9.50 percent to 8.50 percent in May 2013 has yet to have the desired impact hence the credit growth in the second half of the Fiscal Year 2012/13 remained sluggish mainly on account of reduced demand due to a wait-and-see attitude adopted by investors and producers in the economy in the lead up to the general elections in March 2013. However, credit growth at both the aggregate and sectoral levels picked-up from an annual growth of 9.5 percent in May 2013 to 12.7 percent in June 2013 reflecting a gradual improvement in economic activity but is yet to achieve its target level.

Chart 2: Annual Growth in Private Sector Credit (%)



Source: Central Bank of Kenya

ii. Monetary Programme

Consistent with the outcome on inflation during the second half of the Fiscal Year 2012/13, the CBK met the monetary programme targets (Table 1). In order to achieve its price stability target the CBK conducted monetary policy based on the monetary aggregate targeting framework. The targets pursued under the framework are consistent with those for Net Domestic Assets (NDA) and Net International Reserves (NIR) in the ECF programme.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13
Actual Broad Money,M3 (Ksh Billion)	1,727.3	1,729.6	1,747.6	1,755.5	1,802.0	1,823.1	1,820.6
Target Broad Money,M3 (Ksh Billion)	1,774.1	1,747.2	1,766.9	1,786.5	1,806.6	1,826.3	1,846.1
Actual Reserve Money (Ksh Billion)	293.6	274.0	287.1	287.6	267.8	281.9	287.4
Target Reserve Money (Ksh Billion)	279.5	266.3	278.8	280.5	280.3	279.9	282.6
Actual Net Foreign Assets of CBK (Ksh Billion)	364.1	345.1	325.7	341.7	376.4	399.5	402.1
Targets for Net Foreign Assets of CBK (Ksh Billion)	334.5	327.7	328.4	328.4	331.7	335.0	338.1
Actual Net Domestic Assets of CBK (Ksh Billion)	-70.5	-71.1	-38.6	-54.1	-108.5	-117.7	-114.7
Target Net Domestic Assets of CBK (Ksh Billion)	-55.0	-61.4	-49.6	-47.8	-51.4	-55.1	-55.5
Actual Credit to private sector (Ksh Billion)	1,283.9	1,297.5	1,306.2	1,316.0	1,326.2	1,338.8	1,367.2
Target Credit to private sector (Ksh Billion)	1,358.1	1,299.8	1,325.4	1,339.0	1,365.6	1,390.8	1,400.8
Memorandum Items							
12-month growth in actual RM (Percent)	15.1	12.2	23.9	11.5	9.5	18.9	11.7
12-month growth in actual M3 (Percent)	14.1	14.9	16.1	15.7	17.3	16.7	14.2
12-month growth in actual credit to private sector (Percent)	10.4	12.0	11.5	11.2	10.4	9.5	12.7

Source: Central Bank of Kenya

The predictability of money demand has continued to be affected by an unstable money multiplier and decline in the velocity of money in circulation. During the second half of the Fiscal Year 2012/13, the velocity of money remained fairly stable at about 2.0. However, the money multiplier remained unstable and fluctuated between 6.1 and 6.7 during the period. This reflected an increase in cash in till of banks.

In order to enhance the monetary policy transmission mechanism, the CBK continued to implement measures aimed at improving the efficiency of the banking sector as well as financial inclusion. Commercial banks' branch network increased from 1,272 in December 2012 to 1,280 in March 2013 while the number of ATMs increased from 2,381 in December 2012 to 2,439 in June 2013. The increase in the number of ATMs was distributed across all the counties in the country. Similarly, the Agency Banking model continued to expand with the number of Agents standing at 19,649 by June 2013 while the number of transactions was 58.6 million valued at Ksh 310.5 billion. In addition, a total of 13 commercial banks had been licensed by the CBK to undertake Agency transactions by June 2013.

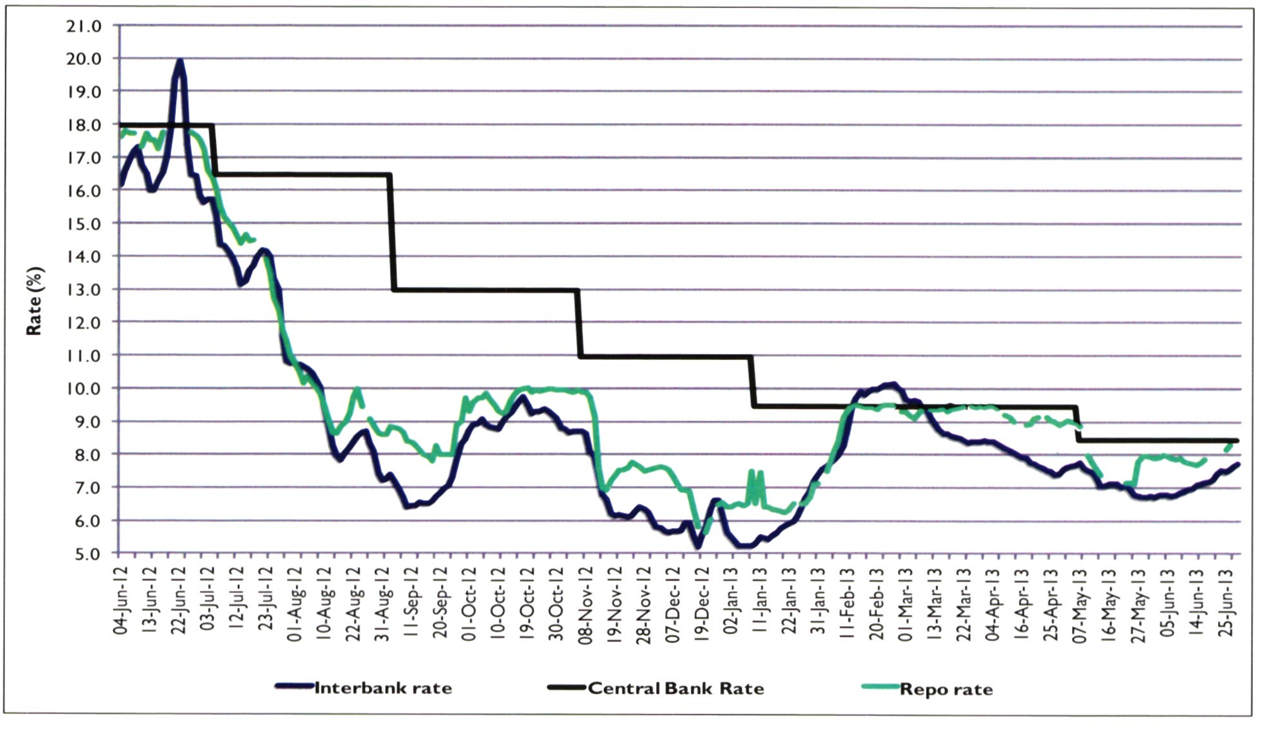
Mobile phone money transfers have continued to affect financial intermediation through the reduction of transaction costs. Commercial banks have continued to partner with telecommunication companies to offer financial services on telecommunication platforms. Financial innovations have changed the design and conduct of monetary policy.

iii. Interest Rates and Liquidity

The gradual easing of the monetary policy stance coupled with sustained Open Market Operations (OMO) resulted in improved liquidity and stability in the interbank market. The CBR was reduced from 11 percent on 7th November 2012 to 9.50 percent on 10th January 2013, maintained at that level in March 2013, and lowered to 8.50 percent on 7th May 2013. The decisions of the MPC were operationalised through OMO thereby ensuring that movements in short-term rates were aligned to the CBR (Chart 3).

The improved liquidity conditions in the market coupled with a high penal rate above the CBR on the CBK Discount Window facility ensured its proper use as a last resort source of funds. The banks accessed a lower amount of funds totalling Ksh 10.098 billion from the CBK Discount Window in the second half of the Fiscal Year 2012/13 compared with Ksh 115.16 billion in a similar period of 2012 when a tight monetary policy stance had been adopted by the CBK.

Chart 3: Trends in Short Term Interest Rates (%)

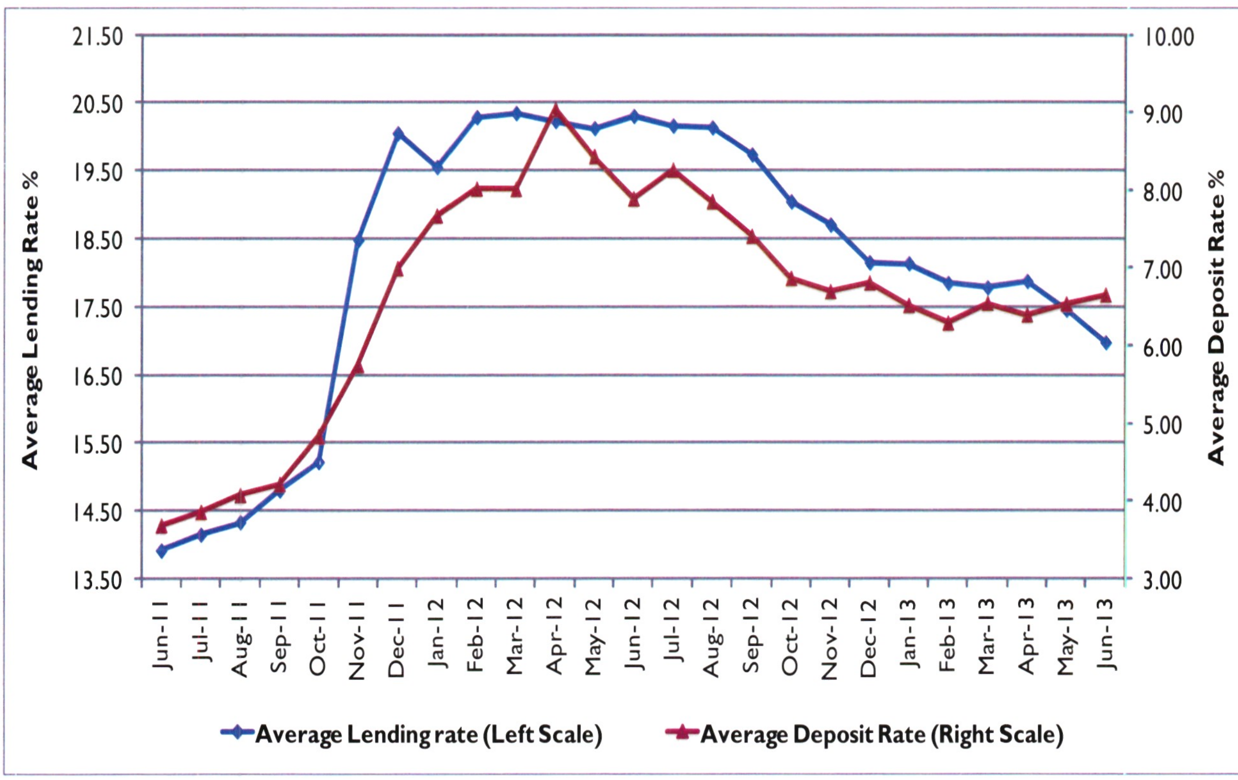


Source: Central Bank of Kenya

Average commercial banks' lending and deposit interest rates declined gradually in the second half of the Fiscal Year 2012/13 reflecting improved liquidity conditions in line with the monetary policy stance adopted by the MPC (Chart 4). The average ex-ante commercial banks lending rates decreased from 18.15 percent in December 2012 to 16.97 percent in June 2013 while the average ex-ante deposit rates declined slightly from 6.80 percent to 6.65 percent during the period. Consequently, the average ex-ante interest rate spread declined slightly from 11.34 percent to 10.32 percent in the period.

The CBK has been working with the Kenya Bankers Association (KBA) to implement initiatives aimed at reducing the cost of doing business in the banking sector. These initiatives include allowing banks to use mobile phone financial platforms that leverage on technology development to reduce transaction costs, adoption of the Agency Banking framework, and operationalisation of Credit Reference Bureaus which have reduced the costs of information search and risk profiling process. In addition, opening of Currency Centres across the country have reduced costs associated with transporting cash. The MPC has also continued to engage the Chief Executive Officers of commercial banks through the KBA on this issue through bi-monthly forums.

Chart 4: Trends in Commercial Bank Interest Rates (%)



Source: Central Bank of Kenya

b. Exchange Rates and Foreign Exchange Reserves

The foreign exchange market remained generally stable during the second half of the Fiscal Year 2012/13 reflecting the impact of monetary policy measures in place (Chart 5a). Exchange rate stability during the period was supported by increased inflows of diaspora remittances that averaged USD 103.9 million per month, disbursement of the USD 108.5 million under the ECF programme in April 2013, and increased purchases of equity by foreigners at the Nairobi Securities Exchange. In addition, effective liquidity management, positive market sentiment, continued build-up of foreign exchange reserves and increased confidence after the elections in March 2013 also supported the Kenya

Shilling during the period. Interbank purchases of foreign exchange amounted to USD 941.50 million in the second half of the Fiscal Year 2012/13 which fully compensated for the policy related foreign exchange sales in the period.

In the region, the Kenya Shilling remained stable against the currencies of the major East African Community countries but strengthened significantly against the South African Rand during the period (Chart 5b). The Rand has weakened substantially against the US Dollar reflecting the strong trade links between South Africa and the turbulent Eurozone, the impact of the labour crisis in the mining sector, and the gradual recovery of the US economy.

Exchange rate stability remains vulnerable to the high current account deficit which was estimated at above 10 percent of GDP, on an annual basis, during the period. The high current account deficit largely reflected a high import bill comprising mainly of machinery and other capital goods coupled with subdued foreign exchange inflows through tourism and trade with Europe mainly due to the instability in the Eurozone and the concerns related to the elections.

Chart 5a: Trends in the Kenya Shilling Exchange Rate against Major Currencies

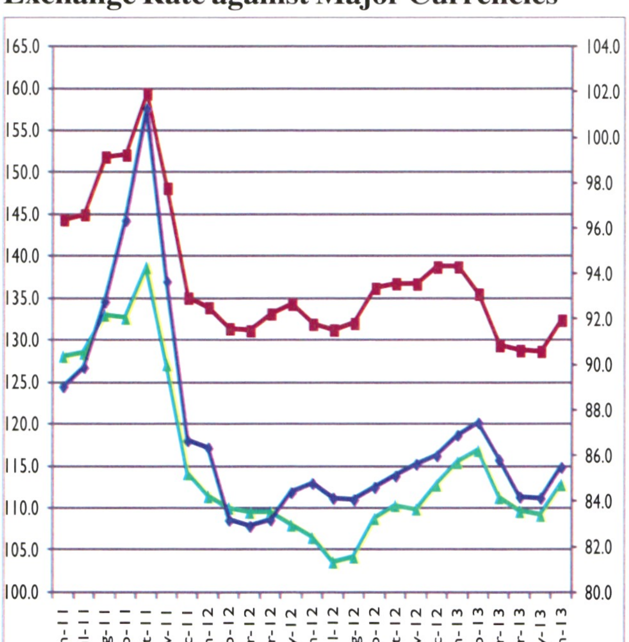
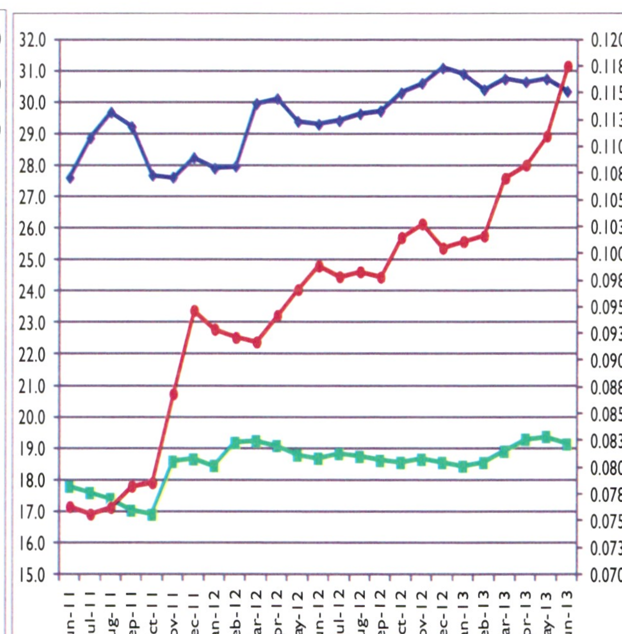


Chart 5b: Trends in the Kenya Shilling Exchange Rate against Regional Currencies

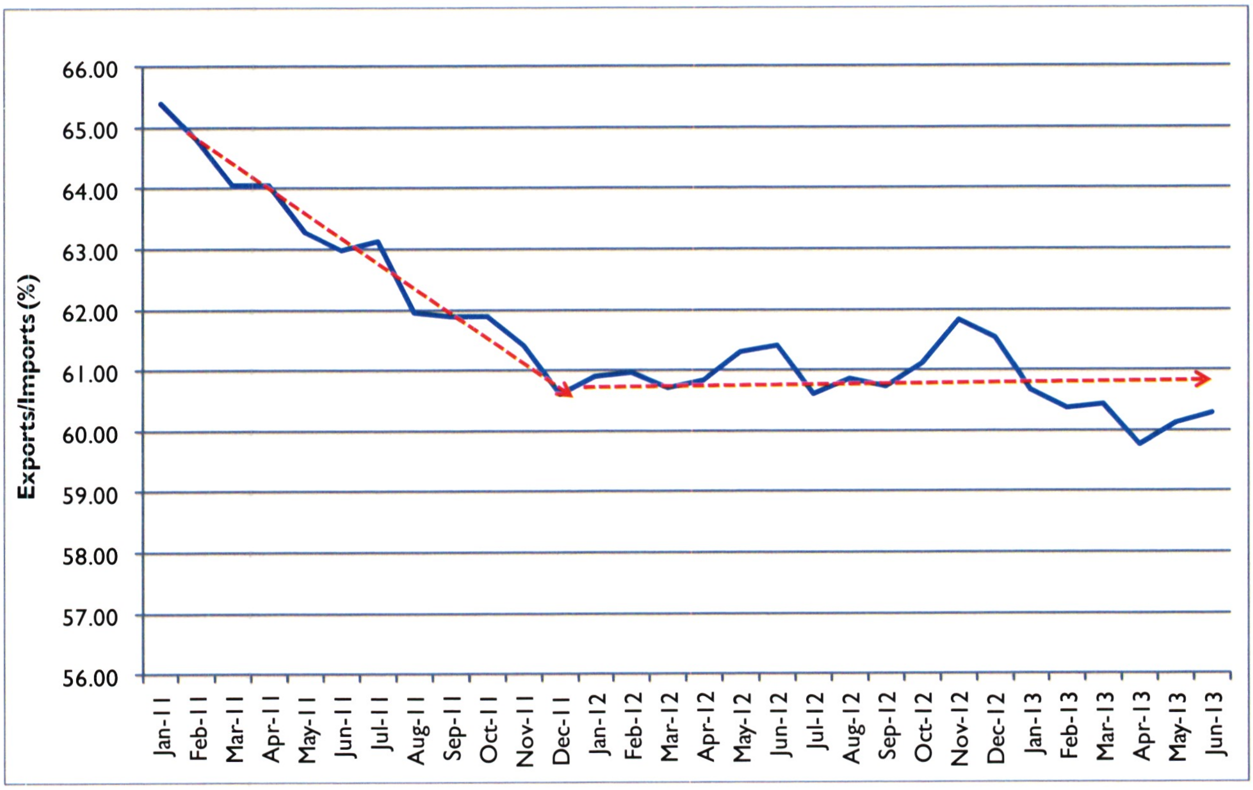


Source: Central Bank of Kenya

The proportion of imports of goods and services financed by exports of goods and services that had stabilised at about 61 percent in the first three quarters of 2012, increased slightly to 63 percent in November 2012 due to a one-off large value export of non-factor services (Chart 5c). It however, declined to about 60 percent by June

2013. The general long-term downward trend reflects the availability of import financing and a general adjustment in the structure of imports and exports. Imports of machinery and other equipment continue to account for an increasing proportion of the import bill from an average of 24.9 percent in the first half of 2012 to 27.1 percent in the first half of 2013. Exports are however still growing at a lower rate compared with imports thereby exerting pressure on the exchange rate.

Chart 5c: 12-Month Cumulative Exports/12-Month Cumulative Imports (%)

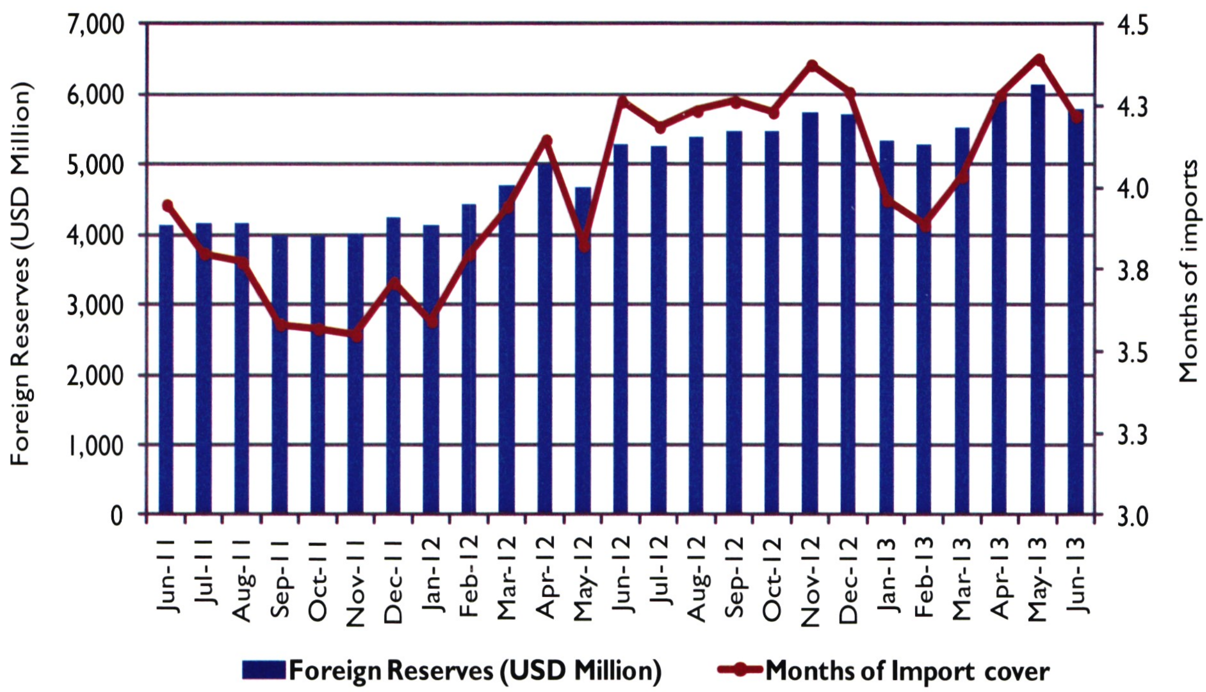


Source: Central Bank of Kenya and Kenya National Bureau of Statistics

The CBK increased its usable foreign exchange reserves from USD 5,680.6 million (4.31 months of import cover) in December 2012 to USD 5,810.60 million (equivalent to 4.22 months of import cover) in June 2013 (Chart 6). This level of foreign exchange reserves is above the minimum requirement of four months of import cover. The disbursement of USD 108.5 million by the IMF in April 2013 following the successful completion of the 5th Review of the ECF Programme, coupled with commercial banks' selling foreign exchange to the CBK, contributed to the build-up of the reserves. In this regard, the CBK purchased foreign exchange totalling USD 941 million against sales of USD 361.5 million in the second half of the Fiscal Year 2012/13.

The build-up in reserves during the period provided a cushion to the foreign exchange market against external shocks.

Chart 6: Foreign Exchange Reserves



Note: Months of import cover computed based on the average imports over the previous 36 months

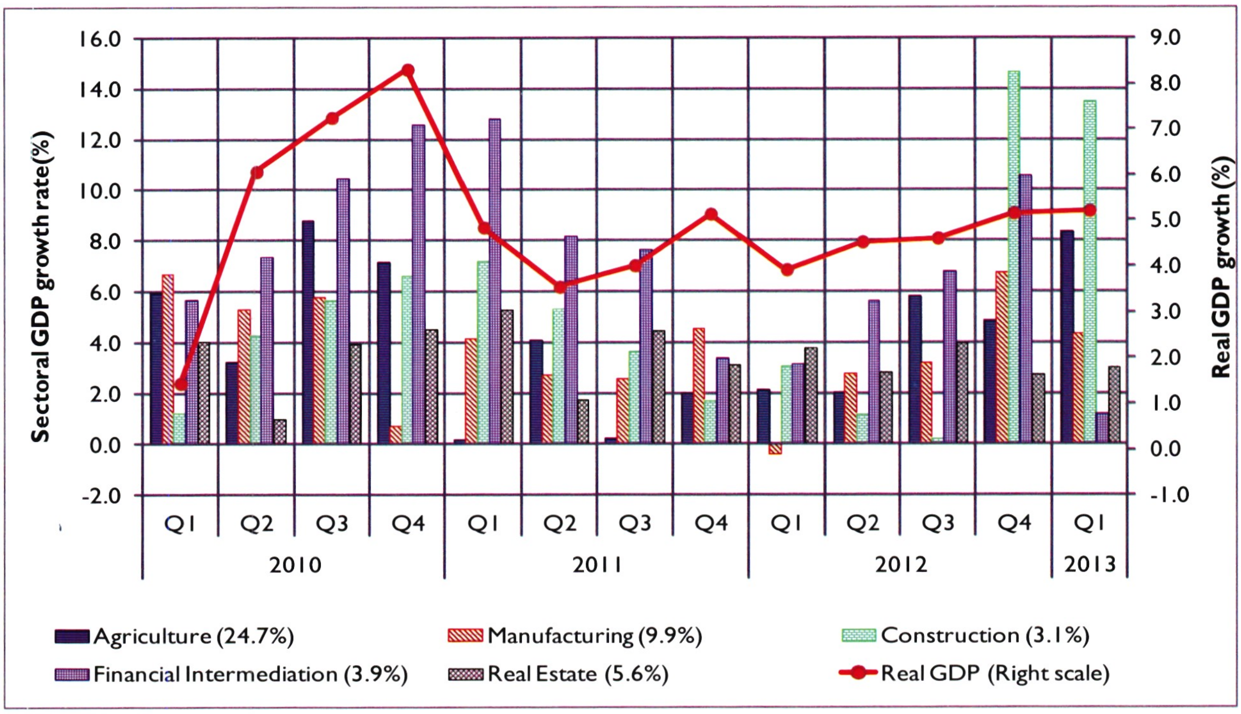
Source: Central Bank of Kenya

c. Economic Growth

Data from the Kenya National Bureau of Statistics (KNBS) shows that the economy registered a strong growth rate of 5.2 percent in the first quarter of 2013 up from 3.9 percent in a similar quarter of 2012 (Chart 7). This mainly reflected the current macroeconomic stability characterised by a low and stable inflation rate and a stable exchange rate, and a strong performance of the agricultural sector which grew at 8.3 percent compared with 2.1 percent in the first quarter of 2012. Improved weather conditions contributed to the strong performance of the agricultural sector in the period.

The manufacturing, hotels and restaurants and financial intermediation sectors registered comparably lower growth rates during the period relative to the first quarter of 2012. This mainly reflected a wait-and-see attitude adopted by producers around the electioneering period. However, the performance of transport and communication, construction, fishing and real estate sectors remained resilient. Volatile world oil prices and the persistent instability in the Eurozone remained the main factors suppressing a stronger growth recovery.

Chart 7: Selected Quarterly Sectoral GDP Growth Rates



Source: Kenya National Bureau of Statistics

Note: *Long term average contribution of the respective sectors to real GDP are given in brackets*

d. Fiscal Developments and Debt

The fiscal measures implemented by the Government in the Fiscal Year 2012/13 were consistent with the monetary policy objectives. The borrowing plan ensured that the build-up in domestic debt was consistent with the thresholds set in the Government Medium Term Debt Management Strategy.

e. Stakeholder Forums, MPC Market Surveys, and Communication

The MPC continued to hold stakeholder forums with Chief Executive Officers of commercial banks through the KBA Governing Council, and potential investors. The Committee continued to improve on the information gathering processes through the bi-monthly Market Perception Surveys. In particular, the coverage of non-bank firms was extended which meant that information on expectations in various sectors and locations was now available. The coverage of the Market Survey captured respondents from Nairobi and around the CBK branches in Mombasa, Kisumu and Eldoret, and Currency Centres in Nakuru, Nyeri, and Meru. Communication with key stakeholders on the MPC decisions were undertaken to obtain feedback.

The MPC also continued to improve on its Press Releases by simplifying them and making them better focused to the public, media, financial sector and other stakeholders. The Press Releases were also published in the widely circulating local dailies. As part of enhancing its capacity, MPC members participated in various conferences during the second half of the Fiscal Year 2012/13. The conferences enable MPC members to share their experiences with other policy experts on critical challenges underlying monetary policy effectiveness in developing countries under different monetary policy frameworks and facing different macroeconomic shocks.

3. The Current Economic Environment and Outlook for Fiscal Year 2013/14

a. International Economic Environment

The global economy is projected to pick-up gradually from an estimated growth of 3.5 percent in 2012 to 3.9 percent in 2013 (Table 2). The Eurozone is projected to remain virtually in recession while only a sluggish growth is projected for the United States in 2013. However, Sub-Saharan Africa and East African Countries (excluding Kenya) are forecast to grow at 5.3 percent and 6.1 percent, respectively, in 2013. Since over 40 percent of Kenya's exports are to the East African region, the strong growth projection for the region is expected to continue to benefit Kenya's export sector.

Despite the projection of a gradual recovery of the global economy, the continued instability in the Eurozone and the MENA region remain the main risk to the growth outlook. Disturbances in the MENA region threaten the marketing of tea exports and the price of oil. The projections of a sluggish recovery from recession in the Eurozone indicate sustained risks to the region's recovery if the momentum for reform is not maintained. These developments could slowdown the performance of tourism and horticulture and exert pressure on the exchange rate in Kenya.

Global inflation that eased from 5.0 percent in 2011 to an estimated 4.0 percent in 2012 is projected to decline further to 3.8 percent in 2013. This reflects the impact of the monetary policy measures adopted by most countries in 2011 and 2012 to rein in inflationary pressures and dampen exchange rate volatility.

Table 2: Performance and Outlook for the Global Economy

	Real GDP Growth (%)			Inflation (%)		
	2011 Act.	2012 Act.	2013 Proj.	2011 Act.	2012 Act.	2013 Proj.
World	3.9	3.5	3.9	5.0	4.0	3.8
Advanced Economies	1.6	1.4	1.9	2.7	2.0	1.6
United States	1.7	2.0	2.3	3.1	2.1	1.8
Japan	-0.7	2.4	1.5	-0.3	0.0	0.1
Euro Area	1.5	-0.3	0.7	2.7	2.5	1.7
United Kingdom	0.7	0.2	1.4	4.5	2.8	2.7
Other Advanced economies	3.2	2.4	3.4	3.0	2.5	2.4
Emerging and developing economies	6.2	5.6	5.9	7.2	6.3	5.6
Sub-Sahara Africa	5.2	5.4	5.3	9.3	9.1	7.2
East African Community (Excl.Kenya)	6.1	5.7	6.1	13.0	12.1	7.1
Developing Asia	7.8	7.1	7.5	6.4	4.5	5.0
China	9.2	8.0	8.5	5.4	2.6	3.0
India	7.1	6.1	6.5	8.9	9.3	10.8
Middle East and North Africa	3.5	5.5	3.7	9.7	10.7	9.4

IMF World Economic Outlook (April 2013)

b. Domestic Economic Environment

i. Economic Growth

The Government Budget Statement for the Fiscal Year 2013/14 projects real GDP to grow by 5.8 percent in 2013 up from a growth of 4.6 percent in 2012. This is expected to be driven by: improving productivity and competitiveness; supporting SMEs through financial and skills development; continued investment in key infrastructure projects in the roads and energy sub-sectors; improving the business environment; improving the quality of education; enhancing security; boosting food security; maintaining a stable macroeconomic environment; sealing revenue leakages in revenue collection system; and, supporting devolution through capacity building.

In addition, the MPC Market Perceptions Survey conducted in June 2013 showed increased optimism by private sector firms (including banks) for a strong growth in 2013 attributed to: growth measures announced in the Budget for the Fiscal Year 2013/14; increased business confidence and prospects for increased foreign direct investment following a peaceful election in March 2013; a stable macroeconomic environment; expected pick-up in economic activity and decline in lending rates; increased regional trade; and, implementation of a devolved Government system which is expected to spur growth in the counties. However, instability in the Middle East and North Africa region and Eurozone, and slow recovery of the global economy were cited as the main risks to the growth outlook.

ii. Foreign Exchange Market

The exchange rate is expected to remain stable in the Fiscal Year 2013/14. Effective liquidity management coupled with the resilient diaspora remittance inflows and expectations for increased foreign direct investment following the peaceful elections in March 2013 support a stable outlook for the exchange rate. In addition, implementation of the proposed amendment to the Customs and Excise Act to introduce a Railway Development Levy of 1.5 percent on all imported goods in the Budget for Fiscal Year 2013/14 is expected, in the medium-term, to ease pressure on the exchange rate by discouraging final consumption imports. The MPC Market Survey for June 2013 corroborated this evidence of an expected stable exchange rate.

iii. Inflation

Overall inflation is expected to remain within Government target bounds in the Fiscal Year 2013/14 on account of the monetary policy measures that have been put in place by the CBK, general stability in the exchange rate, implementation of food security measures as proposed in Fiscal Year 2013/14 Government Budget, improved food supply and lower energy costs following good rains across the country. This inflation outlook is corroborated by the results of the June 2013 MPC Survey. However, the main risks to the inflation outlook include: the likely impact of proposed tax measures in the Fiscal Year 2013/14 Budget under VAT Bill which could result in higher prices of essential goods; expected increase in demand in the economy with pick-up in economic activity; impact of base effects; and volatile world oil prices.

iv. Interest Rates

Interest rates are expected to remain stable with the gradual easing of the monetary policy stance adopted by the MPC following the decline of inflation and improved liquidity conditions in the market. Sustained Open Market Operations by the CBK should also ensure stability of the interbank market interest rates around the CBR. In addition, the MPC Market Perceptions Survey for June 2013 showed that lending rates were expected to decline gradually following the decline in inflation and inflation expectations and the sustained easing of monetary policy by the MPC coupled with enhanced engagements of the Bank with commercial banks through the KBA. The Bank has also continued to monitor developments in non-performing loans with a view to ensure that they do not affect the stability of the banking sector.

The main risk to the outlook on interest rates is the international economic developments or supply side factors which could prompt additional measures by CBK to alleviate any adverse expectations with respect to inflation and /or exchange rate movements.

v. Fiscal Policy

The fiscal measures announced by the Government during the Budget Statement for the Fiscal Year 2013/14 are consistent with monetary policy objectives. Specifically, the Government's domestic borrowing target of Ksh.106.47 billion for the Fiscal Year 2013/14 is significantly below the Ksh.165.7 billion for the previous Fiscal Year. This borrowing, coupled with the planned issuance of a Sovereign Bond during the Fiscal Year, should ensure that domestic borrowing does not exert pressure on interest rates of Government securities.

vi. Confidence in the Economy

Various indicators show that confidence in the economy remains strong (Table 3). The latest World Bank Country Policy and Institutional Assessment rating, undertaken in June 2013, places Kenya as one of the top two countries in Sub-Saharan Africa. The planned issuance of a Sovereign Bond in the Fiscal Year 2013/14 will endorse further the confidence in the economy. In addition, the NSE-20 index remained buoyant in the second half of the Fiscal Year 2012/13 with increased foreign participation. Furthermore, the NSE was listed as one of the top performing stock markets among the frontier economies in May 2013. The increase in net foreign purchases of equity at the NSE shows how quickly the election related uncertainty by foreign investors was reversed.

Diaspora remittances have remained resilient, averaging above USD100 million per month since October 2012. The MPC Market Survey undertaken in June 2013 showed increased confidence in the economy after the peaceful elections in March 2013 with expectations for enhanced foreign direct investment in the country.

Table 3: Indicators of Confidence in the Economy

	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13
12-Month Emigrant Remittances (USD Million)	1,170.9	1,184.1	1,182.5	1,179.7	1,189.1	1,198.2	1,198.5
NSE Index (Jan 1966 = 100)	4,133.0	4,416.6	4,518.6	4,860.8	4,765.2	5,007.0	4,598.2
Net foreign purchases of equity at the NSE (Ksh Million)	2,129.0	2,133.0	-3,927.0	1,810.0	3,025.2	3,474.5	2,602.0

Source: Central Bank of Kenya and Nairobi Securities Exchange (NSE)

4. Future Direction of Monetary Policy in the Fiscal Year 2013/14

Monetary policy in the Fiscal Year 2013/14 will focus on: setting monetary targets which are consistent with the objective of achieving and maintaining a low and stable inflation, encouraging growth, and supporting the long-term sustainability of public debt; and, enhancing access to banking services in order to improve the monetary policy transmission to the benefit of economic growth.

a. Monetary Programme and Foreign Exchange Reserves

The monetary targets for the Fiscal Year 2013/14 are based on the indicators in the Government Budget Policy Statement for the Fiscal Year 2013/14 and the ECF programme targets. The monetary targets for the period are presented in Table 4.

Monetary policy will seek to constrain the annual growth in broad money supply, M3, to 14.2 percent by September 2013, 14.0 percent by December 2013, 13.6 percent by March 2014 and 13.3 percent by June 2014. The NDA of the Bank is projected at Ksh -64.8 billion in September 2013, Ksh -57.1 billion in December 2013, Ksh-76.1 billion in March 2014, and Ksh-87.8 billion in June 2014. The NDA targets are below a ceiling which would threaten stability and are consistent with the indicative ECF programme. The indicative ECF targets for NDA of the CBK are Ksh-35.0 million in September 2013 and Ksh-10.0 billion in December 2013. However, the annual growth in credit to the private sector is projected at 16.9 percent in September 2013, 16.2 percent in December 2013, 15.5 percent in March 2014, and 14.1 percent in June 2014. The indicative ECF targets for NIR targets of the CBK are USD 4,350 million in September 2013 and USD 4,450 million in December 2013. The NIR targets are above a floor which would threaten stability. The monetary policy stance will aim at ensuring that movements in the short-term interest rates are supportive to the Bank's primary objective of price stability.

In the medium-term, these monetary targets are expected to enable the Bank maintain overall inflation within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent in order to anchor inflation expectations. The CBK will continue to build its foreign exchange reserves in order to enhance the country's capacity to absorb shocks that impact the foreign exchange market. The monetary policy stance will aim at ensuring that short-term interest rates remain stable which will support growth and ensure the long-term sustainability of public debt. The Bank will also continue to enhance the effectiveness of its monetary policy instruments with regard to speed and magnitude of impact.

Table 4: Monetary Targets for the Fiscal Year 2013/14

	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13
Broad Money, M3 (Ksh Billion)	1,866.6	1,887.0	1,907.4	1,927.8	1,948.2	1,968.8
Reserve Money, RM (Ksh Billion)	286.0	286.8	288.5	296.8	297.5	312.2
Credit to Private Sector (Ksh Billion)	1,426.1	1,442.5	1,443.8	1,461.0	1,473.0	1,488.6
NFA of CBK in Ksh Billion	343.6	348.4	353.3	358.8	364.1	369.3
NDA of CBK in Ksh Billion	-57.5	-61.6	-64.8	-62.0	-66.6	-57.1
12-month growth in RM (Percent)	11.1	14.6	11.4	18.5	6.4	6.3
12-month growth in M3 (Percent)	15.7	15.2	14.2	13.2	12.0	14.0
12-month growth in Credit to Private Sector (Percent)	16.7	17.6	16.9	16.9	16.6	16.2
12-month growth in Real GDP (Percent)						5.8
Medium-Term 12-month overall Inflation (Percent) Target	5.0	5.0	5.0	5.0	5.0	5.0

	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14
Broad Money, M3 (Ksh Billion)	1,989.3	2,009.7	2,030.0	2,050.7	2,071.0	2,091.5
Reserve Money, RM (Ksh Billion)	302.3	305.9	308.4	310.1	307.2	312.5
Credit to Private Sector (Ksh Billion)	1,508.4	1,532.2	1,546.2	1,564.4	1,568.3	1,598.2
NFA of CBK (Ksh Billion)	374.8	379.7	384.6	389.9	395.3	400.2
NDA of CBK (Ksh Billion)	-72.5	-73.8	-76.1	-79.8	-88.1	-87.8
12-month growth in RM (Percent)	13.5	9.7	9.9	10.6	9.8	11.2
12-month growth in M3 (Percent)	13.9	13.7	13.6	13.5	13.4	13.3
12-month growth in Credit to Private Sector (Percent)	16.0	15.6	15.5	14.6	12.8	14.1
12-month growth in Real GDP (Percent)						6.0
Medium-Term 12-month overall Inflation (Percent) Target	5.0	5.0	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya and the National Treasury

The Bank will continue to monitor developments with respect to the Monetary Targets and make any necessary reviews. The achievement of the targets set will depend on stability in the international prices of oil, favourable weather conditions, and continued commitment by the Government to operate within the domestic borrowing target for the Fiscal Year 2013/14. Monetary policy implementation will be based on monthly targets for NDA, RM and broad money supply, M3, to be achieved through Open Market Operations. The Repos and Term Auction Deposits will be used to withdraw any excess liquidity in the banking system on a timely basis and where necessary Reverse Repos will be used to inject liquidity.

The success of CBK's monetary policy measures to fight inflation will also depend on the effectiveness of the institutions charged with the responsibility of managing the supply side of economy that would have a direct impact on food and fuel prices.

b. Measures to Extend Access to Financial Services and Enhance Market Efficiency

The Bank will continue to support development of new products and innovations towards enhancing financial access in order to encourage economic growth. In this regard it will continue to propose suitable legislation aimed at ensuring that such innovations are regulated accordingly to enhance market confidence. The Bank will also continue to monitor any new financial derivatives and /or innovations in the market that could have adverse effects on market stability. It will also continue to work with stakeholders in the banking and real sectors in order to enhance the monetary policy transmission mechanism. Initiatives aimed at engaging stakeholders and obtaining feedback on the impact of MPC decisions will be enhanced.

The Bank will work with the KBA to identify and implement measures to enhance the uptake of Horizontal Repos among banks. Stakeholder forums with Chief Executive Officers will be held both to obtain feedback and to explain the background to MPC decisions. The MPC will also continue to brief the market on its decisions with a view to coordinate market expectations.

These initiatives will support improvements in the financial sector that contribute to the lowering of the cost of doing business.

ANNEX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JANUARY - JUNE 2013)

January 2013	a) The MPC reduced the CBR by 150 basis points from 11 percent to 9.5 percent.
	b) The CBK sold USD 338.50 million to the market to tame excessive volatility in the market.
March 2013	a) The MPC maintained the CBR at 9.50 percent to allow the previous policy rate adjustments to work through the market.
	b) The CBK purchased USD 181 million from the market to build its foreign exchange reserves.
	c) The CBK introduced weekly auctions of the 364-day Treasury bills. These auctions had previously been conducted on a monthly basis.
	d) A wait-and-see attitude was adopted by investors and producers which slowed down economic activity around the electioneering period.
April 2013	The CBK purchased USD 546 million from the market to build its foreign exchange reserves.
May 2013	a) The MPC reduced the CBR by 100 basis points to 8.50 percent.
	b) The CBK purchased a net of USD 191 million from the market to build its foreign exchange reserves.
June 2013	a) Political disturbances in Egypt and South Sudan
	b) Announcements of commercial viability of Kenya's oil discoveries.

GLOSSARY OF KEY TERMS

Overall Inflation

Overall inflation is a measure of price change in the economy calculated as the weighted year-on-year movement of the indices of the prices paid by consumers of goods and services collected monthly by the Kenya National Bureau of Statistics. The inflation measure is affected by the commodities in the basket some of which may experience sudden price spikes such as food or energy. It may therefore present a distorted picture of the true state of the economy.

Reserve Money

Reserve Money is computed as the CBK's monetary liabilities comprising currency in circulation (currency outside banks and cash held by commercial banks in their tills) and deposits of both commercial banks and non-bank financial institutions (NBFIs) held by the CBK. It excludes Government deposits.

Money Supply

Money supply is the sum of currency outside banks and deposit liabilities of commercial banks. Deposit liabilities are defined in narrower and broader senses as follows: narrow money (M1); broad money (M2); and extended broad money (M3). These aggregates are computed as follows:

M1	Currency outside banking system + demand deposits
M2	M1 + time and savings deposits + certificates of deposits + deposit Liabilities of NBFIs
M3	M2 + residents' foreign currency deposits